

Part III

Administrative, Procedural & Miscellaneous

Section 1035 (Also § 72)

Rev. Proc. 2008-24

SECTION 1. PURPOSE

This revenue procedure addresses the tax treatment of certain tax-free exchanges of annuity contracts under § 72 and § 1035 of the Internal Revenue Code. The interim guidance provided by Notice 2003-51, 2003-2 C.B. 362, is superseded.

SECTION 2. BACKGROUND

.01 Section 1035(a)(3) provides that no gain or loss shall be recognized on the exchange of an annuity contract for another annuity contract. The legislative history of § 1035 states that exchange treatment is appropriate for "individuals who have merely exchanged one insurance policy for another better suited to their needs." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 81 (1954). Section 1.1035-1 of the Income Tax Regulations provides that "the exchange, without recognition of gain or loss, of an annuity contract for another annuity

contract under § 1035(a)(3) is limited to cases where the same person or persons are the obligee or obligees under the contract received in the exchange as under the original contract."

.02 Section 72(e) governs the federal tax treatment of distributions from an annuity contract that are not received as an annuity. Under § 72(e)(2), such amounts generally are taxed on an income-first basis. Section 72(e)(12) provides that all annuity contracts issued by the same company to the same policyholder during any calendar year are treated as a single annuity contract for purposes of § 72(e).

.03 Section 72(q)(1) imposes a 10 percent penalty on withdrawals or surrenders of annuity contracts, unless one of the exceptions enumerated in § 72(q)(2) applies.

.04 In Conway v. Commissioner, 111 T.C. 350 (1998), acq., 1999-2 C.B. xvi, the Tax Court held that the direct exchange by an insurance company of a portion of an existing annuity contract to an unrelated insurance company for a new annuity contract was a tax-free exchange under § 1035. Such a transaction is sometimes referred to as a "partial exchange." The Internal Revenue Service (Service) acquiesced in Conway v. Commissioner. 1999-2 C.B. xvi. See also Rev. Rul. 2007-24, 2007-21 I.R.B. 1282 (receipt of a check under a nonqualified annuity contract and endorsement of the check to a second company as consideration for a second annuity contract treated as a distribution under § 72(e), rather than as a tax-free exchange under § 1035); Rev. Rul. 2003-76, 2003-2 C.B. 355 (direct transfer of a portion of an annuity contract for a new

annuity contract treated as a tax-free exchange under § 1035); Rev. Rul. 2002-75, 2002-2 C.B. 812 (assignment of an entire annuity contract for deposit into a preexisting annuity contract treated as a tax-free exchange under § 1035).

.05 Notice 2003-51 provided interim guidance on partial exchanges. Specifically, section 4 of the notice stated that "the Service, using general principles of tax law, will consider all the facts and circumstances to determine whether a partial exchange and a subsequent withdrawal from, or surrender of, either the surviving annuity contract or the new annuity contract within 24 months of the date on which the partial exchange was completed should be treated as an integrated transaction, and thus whether the two contracts should be viewed as a single contract to determine the tax treatment of a surrender or withdrawal under § 72(e)." If however, a taxpayer could demonstrate that one of the conditions of § 72(q)(2), or any other similar life event, such as a divorce or the loss of employment, occurred between the partial exchange and the surrender or distribution, and that the surrender or distribution was not contemplated at the time of the partial exchange, the taxpayer would not be treated as having entered into the surrender or distribution for tax avoidance purposes.

.06 Treasury and the Service have determined that it is in the interest of sound tax administration to adopt the provisions of Notice 2003-51, with changes, in the form of a revenue procedure. See §601.601(d)(2)(vi) of the Procedure and Administration Regulations. In doing so, Treasury and the Service have determined that the 24-month period referred to in section 4 of Notice 2003-51 should be shortened to 12 months, and the subjective

requirement that certain surrenders or distributions not have been "contemplated" at the time of the exchange should be removed. In addition, Treasury and the Service have determined it is appropriate to make the following clarifications to the rules of Notice 2003-51: First, if the direct transfer of a portion of an annuity contract for a second annuity contract does not qualify as a tax-free exchange under § 1035 and the rules of this revenue procedure, it will be treated as a taxable distribution followed by a payment for the second contract. Second, the rule treating a transfer as a tax-free exchange if one of the § 72(q)(2) conditions is met cannot be satisfied based on a payment described in §§ 72(q)(2)(D) (distribution that is part of a series of substantially equal periodic payments) or (I) (distribution under an immediate annuity). See Rev. Proc. 2008-3, 2008-1 I.R.B. 110, section 5.02 (identifying "partial annuitization" as an area under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication). Third, the Service will not require aggregation pursuant to the authority of § 72(e)(12) or otherwise of two contracts that are the subject of a tax-free exchange under § 1035 and section 4.01 of this revenue procedure, even if both contracts were issued by the same insurance company.

SECTION 3. SCOPE

.01 This revenue procedure applies to the direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract, regardless of whether the two annuity contracts are issued by the same or different companies.

.02 This revenue procedure does not apply to transactions (sometimes referred to as "partial annuitizations") in which the holder of an annuity contract irrevocably elects to apply only a portion of the contract to purchase a stream of annuity payments under the contract, leaving the remainder of the contract to accumulate income on a tax-deferred basis.

SECTION 4. PROCEDURE

.01 A transfer that is within the scope of this revenue procedure will be treated as a tax-free exchange under § 1035 if either--

(a) no amounts are withdrawn from, or received in surrender of, either of the contracts involved in the exchange during the 12 months beginning on the date on which amounts are treated as received as premiums or other consideration paid for the contract received in the exchange (the date of the transfer); or

(b) the taxpayer demonstrates that one of the conditions described by § 72(q)(2)(A), (B), (C), (E), (F), (G), (H) or (J), or any similar life event (such as divorce or loss of employment), occurred between (i) the date of the transfer, and (ii) the date of the withdrawal or surrender.

.02 A transfer that is within the scope of this revenue procedure but not treated under § 4.01 as a tax-free exchange under § 1035 will be treated as a distribution, taxable under § 72(e), followed by a payment for the second contract.

.03 The Service will not require aggregation pursuant to the authority of § 72(e)(12), or otherwise, of two annuity contracts that are the subject of a tax-

free exchange under § 1035 and section 4.01 of this revenue procedure, even if both contracts are issued by the same insurance company, but will instead treat the contracts as separate annuity contracts. See Rev. Rul. 2003-76.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for transfers described in section 3 of this revenue procedure that are completed on or after June 30, 2008.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Notice 2003-51 is superseded.

DRAFTING INFORMATION

The principal author of this revenue procedure is John E. Glover of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue procedure, contact Mr. Glover at (202) 622-3970 (not a toll-free call).